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## CABINET AFFAIRS STAFFING MEMORANDUM

Date: 2/17/84 Number: 168913CA Due By: \_\_\_\_\_

Subject: Cabinet Council on Economic Affairs - Tuesday, February 21, 1984

8:45 a.m. - Roosevelt Room

TOPIC: R &amp; D Tax Credits

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	McFarlane	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input checked="" type="checkbox"/>	<input type="checkbox"/>
EPA	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/	<input type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>	CCHR/Simmons	<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>	CCLP/Uhlmann	<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCMA/Bledsoe	<input type="checkbox"/>	<input type="checkbox"/>
			CCNRE/	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS: The Cabinet Council on Economic Affairs will meet Tuesday, February 21, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

## RETURN TO:

☐ Craig L. Fuller  
Assistant to the President  
for Cabinet Affairs  
456-2823

☐ Katherine Anderson  
☒ Tom Gibson

☐ Don Clarey  
☐ Larry Herbolzheimer

Associate Director  
Office of Cabinet Affairs

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THE WHITE HOUSE

WASHINGTON

February 17, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*  
SUBJECT: Agenda and Paper for the February 21 Meeting

The agenda and paper for the February 21 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider a report from the Working Group on Research and Development Tax Policy. Since the Working Group last reported to the Cabinet Council on October 11, it has held several meetings to consider the questions raised by the CCEA regarding the definition of "research and experimentation." A paper from Assistant Secretary John Chapoton, chairman of the Working Group, is attached.

The Administration is scheduled to testify on this issue on Friday, February 24.

Attachments

THE WHITE HOUSE  
WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

February 21, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on Research and Development Tax Policy (CM # 338)



## DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

February 17, 1984

### MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

Subject: Research and Experimentation Tax Incentives

The Senate Finance Subcommittee on Taxation and Debt Management will hold hearings on Friday, February 24, on S. 2165, the "High Technology Research and Scientific Education Act of 1983." The bill, sponsored by Senators Danforth, Bentsen, Chafee and Mitchell (and Rep. Shannon in the House), would make permanent the tax credit for research and experimental ("R&E") expenses and modify the definition of qualified research for purposes of the credit. The purpose of this memorandum is to discuss the Working Group's conclusions relating to the scope of R&E expenses eligible for the credit.

Section 44F of the Internal Revenue Code currently provides a tax credit equal to 25 percent of the excess of a taxpayer's "qualified research expenses" over the average amount of such expenses during a "base period." The credit is currently scheduled to expire on December 31, 1985. Congress enacted the tax credit for incremental R&E expenditures to encourage industry to undertake the risky R&E activities that may lead to productivity enhancing innovation.

Under current law, the proper interpretation of the term "qualified research expenses" is unclear for purposes of the credit. This imprecision enables taxpayers to argue that the cost of developing virtually every product is a qualifying expense under the R&E credit. Limited experience to date with the credit indicates that over one-fourth of the companies claiming the credit have their principal line of business mainly in the trade, service or financial sectors.

S. 2165 would make the tax credit for R&E expenses permanent. The Administration has supported extending the credit for three years through December 31, 1988. We have opposed making the credit permanent because we believe more time is needed to determine if the credit is operating as an effective incentive.

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S. 2165 adopts a new definition of "qualified research" for purposes of the credit. In general, the proposed changes represent an improvement over existing law and Treasury is generally supportive of the effort. However, we have serious reservations about certain significant elements of this definition.

Under S. 2165, "qualified research" means (i) a planned search or critical investigation (including basic research) undertaken to discover information which may be useful in the development of a new or significantly improved business item of the taxpayer or (ii) applying existing knowledge to develop a new or significantly improved business item of the taxpayer.

The primary difficulty with S. 2165 stems from the definition of "new or significantly improved." A business item of the taxpayer is "new or significantly improved" generally if the predominant portion of the item's new characteristics are functional, rather than stylistic. In practice, this definition will exclude only purely stylistic changes; even trivial functional improvements will qualify.

The definition of research or experimental activities should be targeted to truly innovative activities. In accordance with the consensus of the Working Group, we propose to suggest that the expenses associated with an activity should qualify for the credit only if, as of the time the taxpayer commences the activity: (i) the taxpayer seeks to improve significantly the functional aspects of a "business component" or significantly reduce its cost and (ii) the taxpayer faces substantial technological risk that the activity will not succeed.

The credit should be available only with respect to activities undertaken to obtain a significant functional improvement or cost reduction in a business component. This requirement is intended to disallow the credit with respect to product development costs associated with routine or trivial functional improvements.

We also propose to suggest that a taxpayer face substantial risk that the development activity will not succeed technologically. This requirement will focus the R&E credit on truly innovative R&E activities. One factor in determining whether substantial risk is present with respect

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to a business component is whether comparable items have been developed by the taxpayer or others and whether the process for producing an existing item may be replicated by the taxpayer. The determination whether substantial risk exists should be made separately for each business component and with reference to all existing technology.

The Working Group's conclusion that the definition of R&E activities qualifying for the credit should involve significant functional improvement or cost reduction and substantial risk is premised on the belief that the credit should be targeted to the innovative research and experimental activities that merit a government subsidy. We have attached to this memorandum several examples to illustrate the difference in the application of the R&E credit under S. 2165 and the formulation we propose.

*John E. Chapoton / RAP*  
John E. Chapoton  
Assistant Secretary  
(Tax Policy)

Attachments

Example 1

A biotechnology company develops a new process for producing insulin from a genetically engineered organism. Insulin is available from other sources, but the process used by the company is innovative.

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|----------------------------------|---|
| S. 2165                          | - Expenses would qualify because characteristics of new process are functional.   |
| Proposed Administration Position | - Expenses incurred in developing new process for producing insulin would qualify because of existence of substantial technological risk. |

### Example 2

IBM develops and markets a new personal computer. In developing the new personal computer, IBM used existing technology, except that the monitor sold with the computer incorporates a new type of screen which produces better graphics and reduces eye strain on the user.

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|----------------------------------|---|---|
| S. 2165                          | - | All costs of developing the new computer would qualify because the development activity resulted in a functional improvement.                                   |
| Proposed Administration Position | - | Only the costs of developing the new screen would qualify because no substantial risk existed with respect to the other aspects of developing the new computer. |



Example 3

Company A asks its engineers to develop a coffeemaker which incorporates an automatic timer. Each of these components is readily available and incorporate well-established technology. The engineers' primary concern is to combine the necessary elements at the lowest possible cost and to make the coffeemaker reliable and space efficient.

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|----------------------------------|---|
| S. 2165                          | - Expenses of developing the coffeemaker would qualify because the coffeemaker's new features are functional. |
| Proposed Administration Position | - No substantial risk is involved in producing the coffeemaker and, thus, the expenses would not qualify.     |